

# International Corporate Rescue



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## The Municipality Strikes Back: *In re City of Vallejo, California*

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### Introduction

On 23 May 2008, the City of Vallejo, California ('Vallejo'), became the largest city in California history to seek protection under chapter 9 of the title 11, United States Code (the 'Bankruptcy Code'). The Bankruptcy Code is somewhat unusual among insolvency statutes in that it affords municipalities the opportunity to restructure their debts through a federally sanctioned proceeding, the rules governing which are found in Bankruptcy Code chapter 9. Burdened by excessive labour costs and pension obligations, and faced with declining revenues – driven largely by a depressed real estate market – Vallejo faced a substantial budget deficit. Negotiation with labour unions proved fruitless, and efforts to trim other costs and boost revenue were insufficient. Unable to increase real estate taxes without voter approval, and unable to borrow funds due to its inability to adopt a balanced budget, Vallejo had little choice but to file for bankruptcy protection.

The labour unions challenged this decision, arguing that Vallejo failed to meet the qualifications for filing chapter 9 in that (i) it was not insolvent and (ii) it had not negotiated with the unions in good faith to achieve a consensual adjustment of its debts. In a recent ruling that has received considerable attention, the United States Bankruptcy Court for the Eastern District of California (the 'Bankruptcy Court') overruled these objections and held that the City of Vallejo was eligible for

protection under chapter 9 of the Bankruptcy Code.<sup>1</sup> As a result, Vallejo will be afforded an opportunity to formulate a chapter 9 plan. Assuming that Vallejo is able to muster sufficient creditor support, Vallejo will be able to use the Bankruptcy Code to implement a financial restructuring.

### Chapter 9 overview

Chapter 9 of the Bankruptcy Code is the chapter governing the adjustment of debts of a municipality, and offers protection for a municipality that is insolvent. Chapter 9 is divided into three subchapters. The first subchapter contains definitions and other general provisions, the second deals with administration of chapter 9 cases, and the third addresses the chapter 9 plan process, including the filing, modification and confirmation of a plan, the effect of confirmation, and the continuing jurisdiction of the court following plan confirmation.

To be eligible for chapter 9 protection, the filing entity must satisfy the statutory criteria of Bankruptcy Code section 109(c).<sup>2</sup> Generally, section 109(c) requires a filing entity to establish (i) that it is a municipality, (ii) that it is specifically authorised under state law to be a debtor under chapter 9, (iii) that it is insolvent, (iv) that it desires to implement a plan to adjust its debts, and (v) has either (A) obtained agreement of a majority of

### Notes

- 1 See Findings of Fact and Conclusions of Law, dated 5 September 2008, Case No. 08-26813, US Bankruptcy Court for Eastern District of California (the 'Ruling').
- 2 Bankruptcy Code section 109(c) provides:
  - '(c) An entity may be a debtor under chapter 9 of this title if and only if such entity –
    - (1) is a municipality;
    - (2) is specifically authorized, in its capacity as a municipality or by name, to be a debtor under such chapter by State law, or by a governmental officer or organization empowered by State law to authorize such entity to be a debtor under such chapter;
    - (3) is insolvent;
    - (4) desires to effect a plan to adjust such debts; and
    - (5) (A) has obtained the agreement of creditors holding at least a majority in amount of the claims of each class that such entity intends to impair under a plan in a case under such chapter;
    - (B) has negotiated in good faith with creditors and has failed to obtain the agreement of creditors holding at least a majority in amount of the claims of each class that such entity intends to impair under a plan in a case under such chapter;
    - (C) is unable to negotiate with creditors because such negotiation is impracticable; or
    - (D) reasonably believes that a creditor may attempt to obtain a transfer that is avoidable under section 547 of this title.'

creditors of each class of impaired claims, (B) negotiated with creditors in good faith and failed to obtain agreement, (C) been unable to negotiate with creditors, due to impracticability, or (D) reasonably determined that a creditor may attempt to obtain a preferential transfer that is subject to avoidance. A debtor that meets each of the requirements of subparagraphs (i) through (iv) and at least one of the requirements of sub-subparagraph (A) through (D) of subparagraph (v) will be eligible to be a chapter 9 debtor.

Although the Bankruptcy Code grants bankruptcy courts authority over chapter 9 proceedings, it does so in a manner that respects state sovereignty over municipalities. For instance, Bankruptcy Code section 903 expressly states that chapter 9 'does not limit or impair the power of a State to control, by legislation or otherwise, a municipality of or in such State in the exercise of the political or governmental powers of such municipality, including expenditures for such exercise.' Thus, while the Bankruptcy Code can serve as a useful tool for a municipality seeking to restructure its obligations, it is clear that chapter 9 cannot be used by creditors to coerce a municipality into a debt adjustment arrangement, nor can a municipality be forced into an involuntary bankruptcy proceeding.<sup>3</sup>

The filing of a petition commences the chapter 9 case. Parties in interest are given the opportunity to object to the petition. If one or more objections are filed, 'the court, after notice and a hearing, may dismiss the petition if the debtor did not file the petition in good faith or if the petition does not meet the requirements of this title.' The debtor has the burden of establishing the requirements of Bankruptcy Code section 109(c).<sup>4</sup>

If the court concludes the debtor is eligible for chapter 9 protection, the court will enter an order for relief, and the debtor will embark on an effort to formulate a plan of restructuring that is acceptable to the majority of the debtor's creditors. The debtor enjoys the exclusive right to file a chapter 9 plan, and unlike chapter 11 (the chapter most frequently employed by large corporations seeking to reorganise), is not faced

with a statutory deadline for filing a plan. On the other hand, Bankruptcy Code section 941 specifies that if the debtor did not file a plan at the time it filed its chapter 9 petition, 'the debtor shall file such a plan at such later time as the court fixes.' Viewed in the context of a statute that establishes immovable deadlines for filing a chapter 11 plan, section 941 suggests that bankruptcy courts have broad discretion in setting (and extending) the date by which a municipality must file a chapter 9 plan.

In order to confirm a plan under chapter 9, the plan must satisfy the criteria of Bankruptcy Code section 942.<sup>5</sup> In addition to compliance with the other provisions of chapter 9, and the other provisions of the Bankruptcy Code that are applicable in chapter 9 cases, section 942 specifies that the debtor must not be prohibited by law from taking any action necessary to implement the plan. Section 942 also specifies that the debtor must have disclosed all amounts paid by the debtor to any person for services in the case, and that the chapter 9 plan must provide for payment in full of all expenses of administering the case. Finally, confirmation of a chapter 9 plan requires that the plan be feasible and that it be in the best interests of creditors. Chapter 9 thus gives municipalities flexibility in adjusting their outstanding debt obligations, but keeps intact the requirement that creditors be treated fairly and equitably (i.e., that they receive a distribution that is at least equal to what they would receive in a liquidation).

## Prior uses of chapter 9

Chapter 9 cases are rare; large chapter 9 cases are extremely rare. Perhaps the most noteworthy use of chapter 9 involved the 1994 filing by Orange County, California. Orange County was driven to seek chapter 9 protection in the wake of a financial crisis resulting from improvident use of derivative financial products. Ultimately, Orange County was able to restructure

## Notes

3 See Bankruptcy Code § 303(a) (providing that an 'involuntary case may be commenced only under chapter 7 or 11 of this title').

4 See Ruling at 44 (citing *In re County of Orange*, 183 B.R. 594, 599 (C.D. Cal. 1995)).

5 Section 942(b) provides:

'(b) The court shall confirm the plan if –

- (1) the plan complies with the provisions of this title made applicable by sections 103 (e) [1] and 901 of this title;
- (2) the plan complies with the provisions of this chapter;
- (3) all amounts to be paid by the debtor or by any person for services or expenses in the case or incident to the plan have been fully disclosed and are reasonable;
- (4) the debtor is not prohibited by law from taking any action necessary to carry out the plan;
- (5) except to the extent that the holder of a particular claim has agreed to a different treatment of such claim, the plan provides that on the effective date of the plan each holder of a claim of a kind specified in section 507 (a)(2) of this title will receive on account of such claim cash equal to the allowed amount of such claim;
- (6) any regulatory or electoral approval necessary under applicable nonbankruptcy law in order to carry out any provision of the plan has been obtained, or such provision is expressly conditioned on such approval; and
- (7) the plan is in the best interests of creditors and is feasible.'

11 USC §942(b).

nearly USD 2 billion of debt and emerge from bankruptcy. Prior to the Orange County filing, the most notorious chapter 9 filing was undoubtedly that of the city of Bridgeport, Connecticut, in 1991. In the Bridgeport case, following a motion by the Connecticut attorney general, the Bridgeport case was dismissed, based upon the court's finding that the city had not exhausted its ability to borrow funds and thus was not insolvent.

## Background of the Vallejo situation

Vallejo is a city with a population of approximately 117,000 located in the San Francisco Bay area, in northern California. The city was founded in the early 1850s, during which time it served two tenures as the state capital. In 1854, the United States established the first west coast US Navy shipyard on nearby Mare Island, and the new township began to flourish and grow. By the time of World War II, the shipyard was the world's biggest ship construction and repair facility, and fueled by the bountiful employment opportunities, Vallejo's population had grown to 100,000.<sup>6</sup>

In 1993, at the end of the Cold War, Congress voted to close the shipyard. This was a significant blow to Vallejo's economy since at the time the closing became effective (in 1996), the shipyard employed more than five thousand workers.

## Vallejo's financial crisis

By the mid-2000s, Vallejo was facing significant budget deficits. For the fiscal year ending 30 June 2006, the deficit was USD 3.2 million, and for the period ending 30 June 2007, the deficit had grown to USD 4.2 million. Prior to filing for bankruptcy protection, Vallejo projected a deficit for the fiscal year ending 30 June 2008 as USD 4.2 million, with either no reserve or a deficit in the city's general fund from which operating expenses were paid.<sup>7</sup>

The city's general fund receives revenues from Solano County and the State of California, based upon property taxes, sales taxes, and other fees and assessments. In 2008, these revenues were diminished by decreased state funding, the loss of sales tax revenue resulting from the closing of a Wal-Mart store, and other negative events. At the same time, Vallejo was faced with

increased costs, including an unexpected (and thus unbudgeted) obligation to pay approximately USD 3.4 million to a group of police officers and firefighters that elected early retirement. This turn of events made worse an already dire situation.<sup>8</sup>

Vallejo had recognised the impending crisis as early as the 2003-2004 fiscal year, and had implemented measures to reduce costs, including reducing the city payroll by 87 full-time positions. Vallejo also slashed municipal spending on street maintenance, vehicle replacement and a host of community services, including its senior center, library, parks and other programs and services. Between December 2006 and June 2007, Vallejo identified approximately USD 10 million in savings through cuts to city services and programs that could be implemented without agreement of another party. These reductions failed to eliminate the projected budget deficit, and in December 2007, members of city's staff presented the city council with an analysis indicating that the city's general fund would be depleted prior to the end of the fiscal year. To address the budget gap, the staff recommended that Vallejo engage in discussions with the unions<sup>9</sup> representing a majority of the city work force, in an attempt to obtain economic concessions from the unions under their collective bargaining agreements (the 'CBAs') as one component of an overall restructuring plan.<sup>10</sup>

Vallejo met with the unions on 10 December 2007 and provided the unions with information regarding the city's precarious financial situation and the looming insolvency of the general fund. Despite several follow-up meetings, Vallejo and the unions were unable to reach agreement on modifications to the CBAs. As a result, on 28 February 2008, the city staff recommended that Vallejo seek protection under chapter 9 of the Bankruptcy Code. However, before Vallejo's city council considered this recommendation, the city and the two largest unions entered into an agreement modifying, on an interim basis, their CBAs. Under this interim agreement, the city agreed to settle various grievances and litigation pending with the unions. In return, the unions agreed to a 6.5% wage rollback and agreed to concessions regarding the number of firefighters and sworn police officer positions set forth in the CBAs. In accordance with the interim agreement, the parties agreed to participate in mediation for 45 days. The stated goals of the mediation were to discuss potential cost reductions, revenue enhancements and CBA modifications that would permit funding of

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### Notes

6 See <[www.visitvallejo.com/about-vallejo/](http://www.visitvallejo.com/about-vallejo/)>.

7 See Ruling, at 2.

8 *Id.* at 9.

9 The unions include the Vallejo Police Officers Association, the International Association of Firefighters, the International Brotherhood of Electrical Workers and the Confidential, Administrative, Managerial and Professional Employees Association of Vallejo.

10 Ruling, at 8-9.

essential city services and provide a positive general fund reserve at the end of each fiscal year through 30 June 2012.<sup>11</sup>

The city met with the unions eleven times during March, April and May 2008, and discussed ways of achieving expenditure reductions and revenue enhancements, as well as potential modifications to the CBAs.<sup>12</sup> The parties exchanged numerous written proposals involving proposed salary roll-backs, extensions of the CBAs and salary 're-openers' tied to Vallejo's financial situation. On 14 May 2008, Vallejo sent to the unions a proposal that provided for maintaining salaries at the levels consistent with the interim agreement, a two-year extension of the CBAs and salary re-openers. This proposal also contained terms regarding certain additional expenditure reductions and revenue enhancements. The unions did not accept this proposal, but within two days, countered with their own proposal. The city rejected the union proposal as it failed to meet the stated mediation objectives in that it would not permit the city to provide essential services and maintain a positive general reserve fund beyond one year. Unable to reach an agreement with the unions, Vallejo filed a petition for protection under chapter 9 of the Bankruptcy Code on 23 May 2008.<sup>13</sup>

### City of Vallejo's chapter 9 case

In connection with the filing of Vallejo's chapter 9 petition on 23 May 2008, the city requested that the Bankruptcy Court establish 27 June 2008 as the deadline for filing objections to Vallejo's petition and the accompanying statement of qualifications. The Bankruptcy Court granted this relief, and as a result, on or before 27 June 2008, various parties, including the unions, filed motions seeking to have the case dismissed on the basis that (i) Vallejo failed to satisfy the eligibility requirements for chapter 9, and (ii) the case had been filed in bad faith.

In the meantime, on 17 June 2008, Vallejo moved to reject its collective bargaining agreements with the unions. The rejection motion was originally scheduled for hearing on 22 July 2008, but was adjourned several times – in apparent recognition of the need to resolve

the threshold issue of whether Vallejo was properly before the Bankruptcy Court, before the court granted such momentous relief as approving rejection of the CBAs.

After further briefing on Vallejo's eligibility under chapter 9, the Bankruptcy Court convened a contested hearing on 23 July 2008. The court conducted hearings on five additional days over the ensuing month, and heard closing arguments on 22 August 2008. On 5 September 2008, the Bankruptcy Court issued the Ruling, holding therein that Vallejo had satisfied the requirements of Bankruptcy Code section 109(c) and was, therefore, eligible to be a debtor under chapter 9.<sup>14</sup>

As an initial matter, the court noted that Vallejo was a political subdivision of the state of California that was authorised to be a debtor under chapter 9, thereby satisfying the requirements of subsections 109(c)(1) and (c)(2).<sup>15</sup> Turning to the issue of insolvency, the court explained that in this context, '[i]nsolvency is determined using a cash flow analysis'.<sup>16</sup> The court noted that a mere budget gap did not establish insolvency, and explained that a chapter 9 debtor must demonstrate that 'it will be unable to pay debts as they come due'.<sup>17</sup> In addition to a budget shortfall, however, Vallejo was unable borrower money as a matter of state constitutional law, and thus was projected to be unable to pay its debts as they come due, supporting the conclusion that Vallejo was insolvent.<sup>18</sup>

Next, the Bankruptcy Court considered whether Vallejo desired to effect a plan of adjustment. The court noted that the city had negotiated in good faith with the unions prior to the bankruptcy filing, but had failed to obtain the unions' agreement on CBA modifications. Based on Vallejo's efforts to achieve an agreement outside the chapter 9 process, the Bankruptcy Court concluded that the city had demonstrated the desire to effect a plan to adjust its debts, and had satisfied the eligibility requirements section 109(c)(5) through its good faith negotiations with the unions. Based upon the comprehensive record before it, the Bankruptcy Court held that Vallejo was eligible for protection under chapter 9 of the Bankruptcy Code.<sup>19</sup>

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### Notes

11 *Id.* at 19-22.

12 *Id.* at 22.

13 *Id.* at 41.

14 *Id.* at 44.

15 *Id.* at 44 (noting that 'California Government Code section 53760 provides that "except as otherwise provided by statute, a local public entity in this state may file a petition and exercise powers pursuant to applicable federal bankruptcy law."').

16 *Id.* at 45 (citing *In re City of Bridgeport*, 129 B.R. 332, 337 (Bankr. D. Conn. 1991).

17 *Id.* at 45 (citing *In re City of Bridgeport*, 129 B.R. 332, 337 (Bankr. D. Conn. 1991).

18 *Id.* at 46 (citing Cal. Const., Art. XVI.).

19 *Id.* at 51.

## Discussion

In *City of Vallejo*, the court undertook a detailed factual analysis, and then applied those facts to the relatively straightforward statutory provisions governing chapter 9 eligibility. In the end, it was clear to the court that Vallejo was an eligible municipality that was authorised to seek chapter 9 protection, was unable to pay its debts as they came due, desired to adjust its indebtedness and had, prior to filing its chapter 9 petition, negotiated with the unions in good faith in an attempt to do so. Accordingly, the Bankruptcy Court had little hesitation in entering an order for relief in favour of Vallejo.

The legal reasoning of the *Vallejo* decision is sound, and there does not appear to be any sound basis for challenging the factual findings set forth in the Ruling. The Ruling is replete with references to excessive labour costs (tied largely to the CBAs), declining revenues, the inability to reallocate funds into the general fund for use in current operations and the city's inability to borrow funds or raise taxes to close the budget gap. It is beyond

dispute that Vallejo undertook significant efforts to try to reach agreement with the unions before seeking bankruptcy protection, and that the court properly provided such protection.

It is interesting to note that on 18 September 2008, the unions filed a notice of appeal. Given the extensive findings of fact in the Ruling, and the sound legal reasoning (as described above), the unions' prospects for success on appeal appear to be quite dim. However, given the importance of this decision – in the absence of this decision, Vallejo would not be entitled to utilise the tools available under the Bankruptcy Code, and would not be positioned to reject the CBAs – it is not surprising that the unions would pursue an appeal. Nonetheless, having established its eligibility to be a debtor under chapter 9, Vallejo now must turn to the more difficult task of building creditor consensus for a chapter 9 plan. Given the adroitness with which the city navigated the prepetition negotiations, and the dexterity demonstrated in the early stages of its chapter 9 case, it appears that Vallejo will be up to the challenge.

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